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SIPDIS

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TAGS: ECON EFIN EINV ETRD PGOV PK
SUBJECT: Economy Stable; Growth Predictions Slow

¶1. (SBU) Summary: Pakistan's economic indicators continue to remain stable, according to IMF Resident Representative Paul Ross and former Ministry of Finance official Ashfaque Hassan Khan. It is widely acknowledged that Pakistan will have problems meeting its annual IMF tax revenue target, and Finance Advisor Tarin has told us that addressing this issue is his highest priority (see septel on tax policy). Ross pointed out that fulfillment of pledges from the donors' conference will provide the equivalent of an economic stimulus program, funding social safety net and development projects. Two areas to watch are remittances and exports. Worryingly, Pakistan's overall exports are down, driven by a significant fall in textile exports. In a separate meeting with G-8 Heads of Mission, Finance Advisor Tarin anticipated GDP growth would reach only 2 percent this year, down from initial estimates of 3.5 and then 2.5 percent. End Summary.

¶2. (SBU) Econ officers discussed the current economic situation with IMF Resident Representative Paul Ross and former Ministry of Finance Special Secretary Dr. Ashfaque Hassan Khan. (Note: Khan recently left government, and is now the Dean of the National University of Science and Technology (NUST) Business School. End note.) In a separate meeting with G-8 Heads of Mission, Finance Advisor Shaukat Tarin briefed on his views of the economy. In signs of continued stability, Pakistan's reserves continue to increase, and now stand at USD 7.8 billion, up from USD 3.2 billion in October ¶2008. The exchange rate has stabilized at 80 to 81 rupees to the dollar, after the rupee fell over 13 percent between July and November 2008.

¶3. (SBU) Private inflows have slowed but Pakistan will not have a balance of payments deficit this fiscal year. Both economists agreed that, despite the current macroeconomic stability, the increase in remittances (which may indicate that overseas Pakistani workers are losing their jobs and transferring assets home) and decreases in exports (due to the worldwide economic recession) are two areas to watch. Pakistan's textile exports have decreased by over 9 percent, while overall exports dropped by 3 percent in the first ten months of the fiscal year. This is due to the global recession, domestic energy shortages and high cost of borrowing.

¶4. (SBU) Ross and Khan agreed that the GOP is unlikely to meet its annual IMF tax revenue target. The GOP has revised its target downward - from $16.9 billion to $15.5 billion - but provincial expenditures are still based on the original figure. Pakistan's tax

base is very narrow, with no taxes on agriculture and most services. Ross commented that the GOP is likely to make up the tax revenue shortfalls through the Petroleum Development Levy (PDL), which is projected to add approximately $1.24 billion to the government's coffers in the current fiscal year. (Note: Pakistan pump prices are above current international market prices; the government pockets the difference. However, the Supreme Court has just ordered the GOP to pass on decreases in international oil prices to domestic consumers; the GOP is expected to comply by lowering prices around 10 percent. End note.)

¶5. (SBU) Khan highlighted areas where the government is facing massive tax evasion, including withholding taxes, where the government loses $2.48 to 3.1 billion annually due to the introduction of a self-assessment system not backed up by a robust audit system. Khan also criticized the IMF's tax target, which called for a significant increase in collections, while at the same time mandating that import growth be kept to one percent. Since tariffs on imports represent approximately 45 percent of tax receipts, the IMF target is virtually impossible to meet, Khan argued.

¶6. (SBU) Despite the anticipated tax collection shortfall, Pakistan will meet its fiscal deficit target of 4.3 percent due to cuts in development and current expenditures. (Note: the IMF has indicated that it may relax this target for the next fiscal year in light of the growing IDP-related expenses facing the government. End note.) Ross commented that the GOP is making serious efforts to meet its target, and has eliminated fuel subsidies. However, he is concerned that it will be difficult to phase out electricity

subsidies by June 30, as the GOP has committed to do. Elimination will require a four percent tariff increase, and rate increases combined with blackouts have led to civic unrest in the past. Ross and Khan agreed that Pakistan should tax agriculture, which accounts for 20 percent of GDP but only one percent of tax revenue.

¶7. (SBU) Although the Ministry of Finance has officially projected a 2.5 percent growth rate, based on forecasts for a good harvest and a 4.2 percent increase in services, Finance Advisor Tarin mentioned May 18 that 2.0 percent was a more realistic figure, a number which Ross agreed with. Khan continued to project a one percent or even negative growth rate.

¶8. (SBU) Economic growth has slowed in large part due to tight monetary policy. While the IMF anticipates a 10.8 percent increase in the broad money supply, Khan commented that it will only grow by 4.5 percent. With negative net foreign asset inflows, domestic assets cannot grow sufficiently in the absence of borrowing from the State Bank of Pakistan. Despite tight monetary policy and lower international commodity prices, core inflation remains at 17.9 percent. One reason is the composition of the core inflation index, which includes housing costs (which many Pakistanis do not pay) as a principal component.

¶9. (SBU) Ross stressed that fulfillment of the donors' conference pledges will have the same effect as the financial stimulus plans implemented by U.S., Japan and other countries. While the financial inflows are helpful for Pakistan's balance of payments and reserves buildup, these funds will allow Pakistan to implement social safety net and development programs that it had previously slashed to meet its fiscal targets.

Comment

¶10. (SBU) While the GOP's efforts to meet IMF targets continue, and continue to restore investor confidence to a certain extent, the stringent Fund requirements are making it difficult for Pakistan to grow its way out of the current crisis. We have heard anecdotally from textile manufacturers that a consolidation of the smaller enterprises is taking place, driven by falling demand and the high costs of working capital and of ensuring a reliable power supply. These anecdotal reports have now been confirmed by the recent trade figures.

PATTERSON